Manitoba Telecom Services

ANNUAL REPORT 1996

AR58

Winspear Business Reference Room
University of Alberta
1-18 Business Building
Edmonton, Alberta T6G 2R6

EXTENDING OUR REACH

MTS

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WHO WE ARE

MTS is the preferred full-service provider of communications services in Manitoba. We offer an extensive range of local, long distance, wireless, directory, and online multimedia services to residence customers, businesses, and public sector organizations using our advanced province-wide communications network. As a member of the Stentor alliance, we provide Manitobans with services and capabilities to communicate with each other and to other regions in Canada and internationally. MTS generated a record $589 million in 1996 revenues and had total capital assets of $1.1 billion by year-end.

WHERE WE'RE GOING

Our objective is to grow profitably and to build long-term shareholder value as the preferred full-service provider in Manitoba, by developing and delivering superior communications services that people use in their homes, at the workplace, and on the move. Our goal is to become a single-source provider in converging markets for communications and multimedia products and services.

HOW WE'RE GETTING THERE

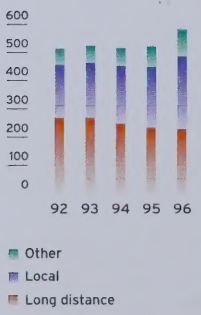
Our strategy is:
Strengthen the core businesses that provide the bulk of revenues and earnings, which are: local, long distance, wireless, directory, and online multimedia services. *Increase service bundling capabilities,* leveraging our strengths as a single-source provider to meet the diverse, expanding communications requirements of Manitobans. *Invest in growth markets* in high-potential areas such as broadband services, personal communications services (PCS), and online multimedia. *Enhance operational performance* by using our province-wide digital network to deploy new services rapidly and cost effectively. *Expand strategic alliances* to increase our competitiveness in core market areas, working with partners to increase our networking, marketing, distribution, and customer service capabilities.

FINANCIAL HIGHLIGHTS

	Years ended December 31	
	1996	1995
	(in thousands)	
Operating revenues	$ 589,325	$ 540,127
Operating expenses	484,582	449,339
Net income	32,400	15,117
Net construction expenditures	135,199	155,931
Investment in property, plant and equipment	2,186,169	2,138,808

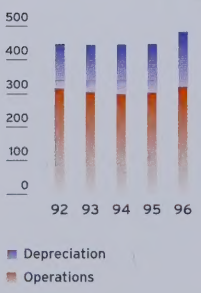
OPERATING REVENUES

(in millions of dollars)



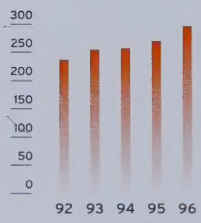
OPERATING EXPENSES

(in millions of dollars)



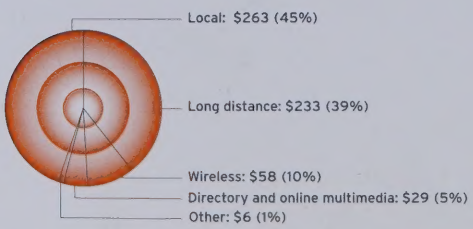
EARNINGS BEFORE INTEREST, INCOME TAXES, DEPRECIATION AND AMORTIZATION

(in millions of dollars)



OPERATING REVENUES

(in millions of dollars)



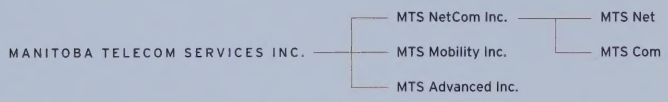
MTS Corporate coordinates the implementation across MTS of business priorities and activities regarding major investment decisions, strategic alliances and network technology planning that cross the boundaries of the operating units. The corporate organization carries out the staff functions of finance, industrial relations, regulatory affairs, legal, public relations, and community relations.

MTS Net operates an integrated, fully digital voice, data and image network that provides a broad range of local and enhanced telecommunications products and services to residence and business customers across Manitoba. MTS is the only provider of basic local services in Manitoba and has an installed base of more than 660,000 network access lines, of which approximately 210,000 are business lines and 450,000 are residence lines.

MTS Com is responsible for long distance services, business telephones, business communications and call centres. MTS offers leading-edge services such as broadband data and enterprise networking applications and systems.

MTS Mobility is the preferred provider of wireless communications services in Manitoba, providing cellular coverage to 95% of Manitobans across its network. MTS Mobility has three core businesses – cellular, paging and group communications networks.

MTS Advanced is responsible for directory services and online multimedia markets. MTS Advanced is the largest commercial online services provider in Manitoba and has launched business initiatives to enter emerging growth markets for electronic commerce and interactive multimedia services. MTS Advanced develops, publishes, and distributes the MTS Yellow Pages™ and MTS White Pages telephone directories.



LETTER TO SHAREHOLDERS

Solid performance and achievements in 1996

Nineteen ninety-six was a year of solid business performance and significant achievements for MTS. The year culminated in our conversion from a provincially-owned Crown corporation to a publicly-traded company effective January 7, 1997.

In 1996, the Company delivered a record $589 million in operating revenues, an increase of $49.2 million or 9.1% above 1995 results. Net income increased significantly to $32.4 million, a 114% increase over the previous year. The solid growth in revenues and earnings can be attributed, in part, to continuing strong growth in the MTS wireless business and local rate increases. In particular, cellular revenues accounted for $17 million of the increase in total operating revenues in 1996. This represents a 42.5% increase over 1995 revenues due largely to a 37% increase in MTS cellular customers. We're pleased by our business performance in a year of major transition for the Company.

Continuing the transformation: privatization

There were numerous business achievements in 1996 in our core telecommunications markets in Manitoba. These achievements are highlighted in this report. Clearly, privatization was the most noteworthy development. The privatization of MTS, after nearly 90 years of provincial government ownership, was an historic turning point in our ongoing evolution into a market-driven, customer-responsive company. In becoming a public company, we've further accelerated that transformation, and, in the process, we've significantly improved our financial strength and decision-making flexibility in positioning MTS for new growth and development as the preferred full-service provider of communications in Manitoba.

As part of the initial public offering (IPO) to privatize the Company, the Manitoba government passed legislation that enabled $400 million of MTS debt owed to the government to be converted into equity. This conversion reduced our debt from $827 million to $427 million, giving MTS a debt ratio in the 40% range – one of the lowest ratios among the major Canadian telecommunicatons services companies. This reduced debt will lower financing costs for MTS by approximately $43 million annually, providing additional cash flow to enhance shareholder value. A federal income tax ruling on the deductibility of company-funded contributions to the MTS pension plan is also favorable to our financial position. The ruling will permit MTS to deduct contributions to its pension plan from taxable income. The resulting non-capital losses of $383 million can be utilized to reduce the taxable income of MTS and its subsidiaries up to a maximum of seven years. Further evidence of our strong financial position, following the recapitalization, are the investment grade bond ratings that MTS received from Dominion Bond Rating Service and Canadian Bond Rating Service – A (low) and A, respectively.

Corporate restructuring and renewal

Effective January 1, 1996, MTS completed a major restructuring into four operating units, allocating business resources and management responsibilities closer to the marketplace. The goal was to improve our responsiveness to customers and to address emerging growth opportunities.

We recognize that, in the aftermath of so much change in 1996, we must now capitalize on our progress in transforming the Company. From our perspective, MTS is moving into the future from a position of strength in Manitoba:

- We are very much a customer-focused company with high levels of customer satisfaction and brand recognition among Manitobans.
- We have the market coverage, networking infrastructure and financial strength to provide our customers with a full range of telecommunications services.
- Because we are a mid-size provider, we are able to respond quickly to the rising expectations of our customers for new services.
- We have one of the most modern digital networks in the Canadian industry and one of the lowest operating cost structures – a major strength.
- We have a skilled workforce that provides MTS with the experience and expertise to deliver communications services across a large operating region.

The challenge: connecting with Manitobans

The challenge ahead for MTS encompasses such major priorities as the need to continue investing in advanced networking systems, improving operational performance, and implementing marketing strategies that deliver consistently profitable results. Our single biggest challenge, and our greatest opportunity, is taking action in all parts of the business to maintain and enhance the loyalty of our customers to MTS. We must maintain and enhance our personal connection with customers in an industry that, in some respects, is increasingly dependent on technology. While we certainly have advanced technology throughout our network and customer service operations, our main differentiating advantage is, and must continue to be, the relationships we've developed with our customers. We have to continuously prove to Manitobans that we understand their requirements and that we have the means to guarantee our promises, to make good on our commitments, and, in the end, to provide superior communications services at prices that deliver the best value for the money.

Looking ahead, we don't underestimate the challenges of a turbulent communications industry in a constant state of transformation and growth. In the past several years, we have made difficult choices and taken aggressive action to position MTS for a successful, profitable future. In an earlier era, the MTS mandate was to affordably extend the reach of communications across the province. It's a legacy of public service that will continue to guide our activities and direction. But as we go forward, as a public company, a new priority will also shape our corporate destiny: the need to create shareholder value. We're ready for the challenge.

In closing, we'd like to take this opportunity to thank our employees and our outgoing Board of Commissioners who, together, have all worked on the transformation of MTS. While this work is never complete, we take pride in our 1996 achievements. At the same time, we're very pleased to welcome to MTS the members of our new Board of Directors. We look forward to working with the new Board to continue the transformation and growth of MTS well into the future.

Tom Stefanson
Chairman

Bill Fraser
President & Chief Executive Officer

January 31, 1997

MTS HAS BEEN ORIENTING ITS BUSINESS OPERATIONS AND PEOPLE TO THE DIVERSE CHALLENGES AND NEW GROWTH OPPORTUNITIES IN A CHANGING TELECOMMUNICATIONS INDUSTRY. TRANSFORMATION IS EVIDENT EVERYWHERE – IN RAPID ADVANCES IN NETWORKING, INTENSIFYING COMPETITION, AND RISING CUSTOMER EXPECTATIONS FOR VALUE. IN THIS ENVIRONMENT, MTS CONTINUES TO MOVE OUTWARD CONFIDENTLY IN SERVING ITS EXTENSIVE CUSTOMER BASE ACROSS MANITOBA. WE EMBRACE THE COMPLEXITIES AND THE PACE OF INDUSTRY CHANGE, LEVERAGING OUR STRENGTHS AND EXTENDING OUR REACH IN NEW DIRECTIONS TO CREATE VALUE FOR OUR CUSTOMERS AND OUR SHAREHOLDERS.

WE'RE EXTENDING OUR REACH...

...AS A FULL-SERVICE PROVI

ur services and capabilities cover the spectrum of communications, enabling

nch into a global economy connected by advanced digital networks

...THROUGH OUR EXPERIENCE...
We have 90 years experience in providing quality, reliable, and affordable telecommunications to Manitobans across the province. Our heritage is our future.

...BY INVESTING IN OUR NETWORK...

Our $1.1 billion in total capital assets includes a province-wide telecommunications network that integrates digital switching, fiber transmission, broadband, wireless and online systems.

...EXPANDING INTO GROWTH MARKETS...

horizons of opportunities are extensive in areas where MTS is investing for future growth: broadband
cations, personal communications services (PCS), and online multimedia and electronic transactions.

...LEVERAGING OUR MANITOBA PRESENCE...

We employ Manitobans from one end of the province to the other. Our people work hard everyday to develop and deliver innovative solutions to meet the changing needs of our customers.

...BEING COMMITTED TO CONTINUO

We are a company in continuous transformation, taking action to respond to

forces, and intensifying competition. Change is our destiny, our route to a profitable

...AND FOCUSING ON CREATING SHAREHOLDER VALUE...
Recapitalization has enabled us to significantly reduce our debt, increasing our financial strength and decision-making flexibility for investing in the business to create new shareholder value.
MANITOBA TEL
MTS

1996 HIGHLIGHTS

Platform for growth

Here's a case where the end is really only the beginning. In December 1996, MTS converted the last remaining analogue switching system in its network to digital switching technology. That achievement completed a multi-year $620 million initiative to modernize the Company's province-wide network. Completion of the "Service for the Future" initiative provides MTS with one of the most advanced and cost-efficient networks in the North American telecommunications industry. The modernized MTS network is a platform to deliver new advanced services to customers well into the future. Says Bill Baines, President and Chief Operating Officer, MTS Net: "The full conversion of our network to digital technology is another milestone for MTS in extending the reach of advanced communications to people and organizations across the province."

Service for the Future had three main thrusts: converting all switching systems in Manitoba to digital technology; replacing some 47,000 party lines in Manitoba with individual line service (ILS); and implementing "community calling" services that allow customers toll-free calling to and within neighboring communities. Last November, MTS completed the ILS component of the modernization by eliminating party-line service in the Shoal Lake area. ILS capabilities are integral to the deployment of advanced services and calling features on the network. Manitoba is one among only four Canadian provinces to have achieved universal individual line service.

The MTS network today includes intelligent signaling platforms such as CCS7, fibre rings and network software. The network meets the highest standards for service integrity, redundancy, and flexible and cost-efficient operations and management. The transmission component of the network includes approximately 150,000 conductor-kilometres of fiber optic systems. In 1995, MTS was among the first Canadian carriers to deploy an ATM (asynchronous transfer mode) broadband network across its operating area.

Wireless growth in the wired world

The emergence of a "wired world" where people stay in touch anytime, anywhere is fast approaching. Growth in wireless services is helping to make it happen. In 1996, MTS Mobility continued its strong growth in its core wireless services markets: cellular, paging and FleetNet™. MTS Mobility finished the year with 86,256 cellular customers, an increase of 37% on a year-over-year basis. Paging customers increased to 10,200, a 25.4% annual increase. The Company's FleetNet operation, which is responsible for group communications networks, nearly tripled its customer base to 950. "We had a year of tremendous achievement in expanding the customer base," says MTS Mobility President and Chief Operating Officer James Fitzgerald. "What's more impressive is that we made these gains profitably

and by solidifying our presence in the Manitoba market as the preferred wireless provider." MTS had an estimated two thirds share of the Manitoba cellular market by year-end. Approximately 12% of Manitobans are cellular customers. Fitzgerald says the outlook for the wireless market is strong. Cellular phones have reached market penetration levels in Canada of 11.4%, which provides significant growth opportunities. Some Scandinavian countries are approaching 30% penetration. The growth prospects in paging are also strong, partly because Canadian penetration rates are relatively low by U.S. and Japanese market standards.

Converging on online television

The convergence of TV and PC has generated enormous interest in recent years. MTS Advanced made a bold step toward accelerating that convergence in 1996 with its InBox Manitoba initiative. In May, MTS Advanced began consumer testing, in 100 Manitoba homes, of a new service which uses a set-top box to transform televisions into inexpensive "online appliances" with e-mail access and other Internet capabilities.

A set-top box, also called a network computer, consists of a VCR-like device with a computer processor and modem. Its software provides access to online entertainment and information services. Says Bruce MacCormack, President and Chief Operating Officer, MTS Advanced: "Network computers are inexpensive and easy to use. Let's face it: many people are intimidated by the high cost and complexity of personal computers. For these people, accessing the online world through the familiar medium of television can help overcome their inexperience with computers."

In December 1996, MTS Advanced and ViewCall America, the developer of the set-top box, formed a new company, ViewCall Canada, Inc., to provide a national television Internet service to Canadians. MTS Advanced is the majority shareholder in the new company, which is expected to launch the television Internet service, called On-TV™, in 1997. The service will provide customers with access to e-mail, news, weather, sports and other electronic information and entertainment services.

Customer-driven innovation

MTS Com is on the front lines of a major challenge: responding to continuously changing customer requirements and their rising expectations for value. During 1996, MTS Com was focused on initiatives to ensure the Company remains the preferred supplier of long distance and competitive services in Manitoba. "We've oriented our entire organization to the idea that customers, if you listen carefully to them, provide the best insight to spur innovation and help us develop new services," says Don Carr, President and Chief Operating Officer, MTS Com. "It's what we call customer-driven innovation."

MTS Com achievements included a restructuring of residential and business savings plans for long distance services; entering into new alliances and partnerships in emerging areas of the business such as prepaid calling cards, virtual customer service centres, and data services; and expanding the number of MTS retail outlets to 73 locations by year-end, including 14 phone centres, 34 phone corners, and 15 phone depots and agent stores. Says Carr: "Our retail presence is a clear advantage that our competitors, despite their intense marketing and advertising, can't match. Phone centres provide a highly visible point of contact with our customers. The level of service our staff and agents provide gives MTS the ultimate competitive advantage: personal face-to-face selling."

An example of how MTS Com is using customer-driven innovation for competitive advantage is an expanded data portfolio that leverages the capabilities in the Company's broadband ATM network. In October, MTS Com launched a high-speed frame relay service designed for Manitoba businesses with multiple, geographically dispersed locations. The service enables key customer applications such as e-mail, online connectivity, file transfer, inventory control, and point of sale and database queries.

In addition, MTS Com is involved in a number of innovative initiatives to deploy advanced communications services more broadly in Manitoba. MTS, in partnership with Stentor and Industry Canada, announced an initiative in 1996 to provide Manitoba schools with increased access to the Internet. Using satellite technology, MTS will provide high-speed Internet access to schools where existing high-speed land lines are not available. The initiative, called SchoolNet, will electronically link students and teachers across Canada to national and international databases.

A little TLC

Some days you wake up and you realize that certain things in life require a little bit more *tender, loving care* – or TLC. That's what MTS Com did in 1996 by embarking on a sweeping transformation of its entire customer service operations. The TLC initiative will, over a three-year period, fundamentally alter the way MTS conducts business. The goal is to create a world-class, customer 'care' operation using the latest service centre and virtual networking technologies. Says Don Carr: "We're re-inventing our relationship with our customers by putting a new, more personal face on the services we provide. It's the rebirth of one-to-one marketing." The initial phase of TLC was nearing completion at the end of 1996. Today, incoming customer calls are automatically routed to service representatives with expertise in residence and business services.

Sponsoring the Pan Am Games

As one of Manitoba's largest companies, MTS has a pivotal role in community life in the province. MTS supports a broad range of social, cultural, educational and sports organizations through direct program funding, in-kind contributions, and the volunteer efforts of employees. MTS also undertakes sponsorship initiatives that provide a showcase for its advanced networking capabilities. In October, MTS became the exclusive telecommunications supplier for the 1999 Pan Am Games to be held in Winnipeg. Says Wayne Wilson, Executive Director, Pan Am Project: "This event is a perfect fit for us because of the beneficial effects on the community in raising Manitoba's profile throughout the Americas. More importantly, our sponsorship reinforces our heritage as a Manitoba company and our commitment to serving Manitobans through our advanced network."

In 1996, MTS also sponsored the provincial Summer Games in Morden and became a major sponsor and exclusive telecommunications supplier for the 1997 Canada Games to be held in Brandon. The Company's sport sponsorship activities are complemented by support for educational institutions and the arts community, including major organizations such as the Winnipeg Symphony Orchestra, the Royal Winnipeg Ballet, and the Manitoba Theatre Centre. Another valuable component of the Company's involvement in community life is the work of the MTS Pioneers, a volunteer group of retired and active employees who dedicate thousands of hours to worthwhile projects around the province.

Rate action

In July 1996, the CRTC approved an application by MTS to restructure rates for local services in rural Manitoba. This revised rate structure consolidated the previous ten rate groups into three. The CRTC also approved rate increases for business service in areas outside Winnipeg and for "community calling" service in rural areas. These changes increased 1996 revenues by approximately $3 million. "Manitoba still has among the lowest telephone rates in Canada," says President and Chief Executive Officer, Bill Fraser. "But rate rebalancing and these other rate actions will allow MTS to more closely align its utility rate structure with the actual costs of providing these services. The key thing to remember is that, in an increasingly competitive marketplace, there will be an incentive to provide customers with value at the best possible price." The CRTC has also directed that rates for local services be increased by $2.00 a month on January 1 in each of the years 1996 and 1997, with a further increase to take effect in January 1998. Each $2.00 local rate increase positively impacts MTS revenues by approximately $14 million per year.

The last word on service

You have our word: service is absolutely key to earning customer loyalty. In July, MTS Net launched an innovative customer service plan that is guaranteed to earn customer loyalty and help the Company succeed when local telecommunications markets become competitive in the future. The plan covers four key areas:

- a 24 hours a day, six days a week (Monday to Saturday) installation schedule;
- appointment scheduling that is precise to two-hour intervals, 24 hours a day, six days a week;
- more options for placing orders for an increasing range of services, including access through an interactive voice response system (IVR) any hour of the day, or online at the MTS website; and
- a service guarantee that entitles customers to receive two calling features for two months, free of charge, if MTS misses a scheduled appointment.

MTS was the first Canadian telecommunications operating company to ask the CRTC for the right to offer its customers a service guarantee. "Many households are headed by two income earners working outside the home," says Sadley Marcinyk, General Manager Customer Services. "They need a narrower timeframe for appointments. As well, some customers work hours that are outside the traditional work day. Our service plan assures these customers we'll be there when they need us." Initially, the plan was rolled out to customers that live in Winnipeg, Brandon, Selkirk, Portage la Prairie, Steinbach and Thompson.

Online growth accelerates

With the June launch in Manitoba of Sympatico™, a nationally-branded Internet service, the growth in the MTS online subscriber base began to accelerate rapidly. By year-end, MTS was the largest commercial online services provider in Manitoba, with approximately 10,000 customers compared to 2,200 customers at the end of 1995. The online multimedia services market is a strategic opportunity for MTS in view of the expansion of the Internet as a commercial infrastructure for transactions, product distribution, and multimedia information and entertainment services. A key MTS Advanced strategy is to expand its distribution channels, technological capabilities and partnerships to enable Manitobans to access online services in much greater numbers.

Covering the spectrum

By extending cellular service to Thompson, Flin Flon and The Pas in 1996, MTS now provides wireless capabilities to over 95% of the Manitoba population. "We cover the spectrum – literally – in providing service," says James Fitzgerald. Twelve new cellular sites were added to the wireless networking infrastructure in 1996. In addition, five new radio sites were added to improve FleetNet service. FleetNet is used by enterprises such as transportation companies, police departments and other emergency services with requirements for dispatch communications.

Partnering on call centres

Growth in telecommunication call centres has been accelerating in recent years because of their success in helping businesses stay in closer touch with customers. MTS is a Canadian leader in starting up telecommunication call centres. The Company has been involved in the startup of more than 70 call centres in Manitoba which has generated additional network revenues. In total, these call centre initiatives have created about 5,000 jobs in the province. In 1996, MTS began a new phase in its call centre strategy by entering into an agreement with IBM Canada Ltd. to jointly develop and market new technologies and services for the call-centre marketplace. "The merging of expertise between MTS and IBM will lead to exciting, innovative and valuable applications to address our customers' call centre needs," says MTS Director of Marketing and Business Development, Dennis McCaffrey.

The new call-centre services will use virtual networking technologies and computer telephone integration (CTI) software. A major goal for MTS is to enable Manitoba businesses to enjoy all the features and benefits of advanced call centre applications without having to purchase the systems and equipment. The call centre software will reside in the MTS network. As well, businesses will also be able to quickly expand or consolidate their call centre applications at minimum cost. With support from IBM and Northern Telecom Canada Limited, MTS is adopting the new call centre technology to transform its own business offices into world-class customer service centres.

Leveraging copper with ADSL

MTS Net began a technical trial of ADSL technology in November 1996 with Internet customers in Winnipeg. ADSL stands for Asymmetric Digital Subscriber Line. It's a technology that enables online users to surf the internet and download large data files in a fraction of the time it currently takes. Using ADSL technology, MTS Net has an opportunity to leverage its large investment in its copper access network. This requires a modem-like ADSL unit at each end of the telephone line to increase data transmission speeds to up to 1.5 megabits, which is about 50 times faster than a 28.8 bps modem speed. ADSL also enables residential customers with a single line to make and receive phone calls while still being connected to an online network on the computer. MTS Net expects to follow up on the ADSL technical trial with a market trial in 1997.

Rolling out enhanced 911

In September, Manitoba-wide access to enhanced 911 calling came another step closer to reality when MTS announced the start of a technical trial in the Brandon area. Using the Company's enhanced 911 database and network, the City of Brandon's central 911 call centre was able to handle 911 calls not only from Brandon but from CFB Shilo, Portage la Prairie, Killarney and the rural municipalities of Cornwallis, Elton, Whitehead and Turtle Mountain. In the enhanced 911 system, the central dispatcher has the correct name, phone number and address of the caller, plus the specific fire, police and ambulance services for that address. This information automatically appears on a computer screen. The correct responder can be rapidly dispatched, even if the caller cannot talk and even if the central dispatcher in Brandon is unfamiliar with the area in Manitoba where the caller is located. Enhanced 911 service will roll out across Manitoba over the next few years.

Evolving to PCS

A new growth opportunity has opened up for MTS Mobility following an Industry Canada announcement, in December 1995, which granted four national licenses to network companies seeking to offer cellular-like services in the 2 GHz range, otherwise known as PCS technology (personal communications services). In Manitoba, two national network operators received PCS licenses along with MTS and the other existing cellular provider. "Cellular will continue to appeal to highly mobile customers because of our extensive networking facilities in Manitoba for these services," says James Fitzgerald. "But we are planning to take advantage of our PCS license by first providing these services in high-density urban locations – like neighborhoods, workplaces and business districts." MTS is planning to launch PCS in late 1997 or 1998.

Yellow Pages in new media

MTS Advanced has been expanding its directory services business beyond the MTS White Pages and MTS Yellow Pages™. One addition is Talking Yellow Pages™, an interactive telecommunications system in which callers access a pre-recorded voice message that corresponds to an advertisement in the print telephone directory. In April 1996, MTS launched the electronic version of its print directories, MTS Internet Yellow Pages, on the World Wide Web. A major growth opportunity is migrating Yellow Pages customers into electronic advertising and transaction services. "Directory services markets are being transformed by Internet search engines that can perform the traditional Yellow Pages function of bringing merchants and buyers together, "says Bruce MacCormack. "We're responding to that reality by introducing new online advertising products and services that help our Yellow Pages customers serve their customers."

CN customer call centre

MTS and Canadian National are all aboard on a major customer call centre project. In October, CN consolidated six customer service centres across the country into a single state-of-the-art location in Winnipeg. The U.S.-based *Teleprofessional* magazine called the location the most up-to-date, high-tech customer service centre in North America. MTS designed and installed the advanced customer call centre equipment, which includes nearly four hundred workstations, and features such as automatic routing and 'screen pops,' providing instant, 'on-screen' customer profiles. The centre, which employs about 500 people, processes approximately 45,000 calls and 20,000 waybills per week.

A message about custom calling features

Many people rely on MTS to provide a broad range of custom calling features such as Call Waiting, Call Display and Three-Way Calling. The growing demand for custom calling features and pay-per-use services is a continuing opportunity for MTS to generate new revenues from the capabilities of its advanced digital network. One recent example of an innovative custom calling feature is Call Messenger. It was launched in July and is currently available in Winnipeg, Brandon and Steinbach. Call Messenger enables customers to broadcast a voice message simultaneously to a group of people – like a hockey coach advising the team of an upcoming practice, or a teacher scheduling a class. MTS was the first Canadian telecommunications operating company to provide this service. "Call Messenger is ideal for associations, volunteer groups, businesses – any person or organization with a requirement for contacting many people with a common message," says MTS Product Manager Brad Ross. "It's a real time-saver."

Mobility in the malls

Increasingly, life is a quest for one-stop shopping, at least it is for wireless communications. In 1996, MTS Mobility opened up 10 new MTS Mobility Centres where customers can purchase cellular and paging hardware, accessories, and services at a single location. The centres are owned and operated by authorized dealers and located in shopping malls and other retail locations. "We want more people to find out about our cellular and paging services," says Gabe Tougas, Retail Development Manager, MTS Mobility. "So we're bringing our products to the malls to make it easy for people to discover the convenience of cellular service." The MTS Mobility centres supplement the Company's extensive distribution network of some 103 independent dealers.

Growing beyond the borders

It's a borderless world because of communications technology, and the same applies to business opportunities when pursued with the right focus. In 1996, MTS Net launched a new line of business, Telecom Related Services (TRS), which provides contracting, refurbishing and training services to other telecommunications operating companies. TRS has the capability to pursue new business opportunities, such as contracting, by re-allocating internal resources which have become available following completion of the Company's network modernization program. To date, TRS has contracted its services to projects in Canada, United States, and Mexico. In January 1997, MTS Net announced a major contract with Pacific Bell, which involves the tempory relocation of 86 employees to California to work on installing network infrastructure there.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

MTS has been repositioning itself to take advantage of new market opportunities, to address increasing competition, and to strengthen its financial position. This has included extensive network modernization; enhancing the services portfolio; focusing on growth opportunities in areas such as wireless and online multimedia; investing in customer service capabilities; improving operating cost performance; and completing a restructuring into four operating units, effective January 1, 1996.

	1996	1995	% Change
	(in thousands)		
Operating revenues	$ 589,325	$ 540,127	9.1
Operating expenses	484,582	449,339	7.8
EBITDA[1]	296,044	259,207	14.2
Net income	32,400	15,117	114.3

(1) Earnings before interest, income taxes (which were not applicable to MTS), depreciation and amortization.

In 1996, the Company recorded $589 million in operating revenues, an increase of $49.2 million or 9.1% over 1995 results. Net income increased significantly to $32.4 million, representing a 114% increase over the previous year. The growth in revenues and earnings can be attributed, in part, to continuing strong growth in the MTS wireless business and local rate increases. In particular, wireless revenues accounted for $17.3 million of the increase in total operating revenues in 1996. This represents a 42.5% increase over 1995 revenues due largely to a 37% increase in MTS cellular customers. MTS is the preferred supplier of wireless services in Manitoba with approximately two-thirds of the cellular market.

An environment of intensifying competition for long distance services marginally decreased long distance revenues by 2.3%. MTS has responded to long distance competition with marketing initiatives that encompass the introduction of new services, better price positioning for existing services, and by investing in innovative customer-care capabilities that support the Company's extensive resource base of employees and networking systems throughout Manitoba.

The Company's financial position has improved in recent years. In 1996, these improvements were reflected in the fact that capital expenditures were fully funded by internally generated cash flow. Free cash flow amounted to $62.5 million in 1996 – of which $16 million was applied to improve MTS' debt ratio to 75.7% from 78.4%. A further significant improvement in financial position occurred subsequent to year-end, effective January 7, 1997, with the conversion of MTS from a provincially-owned Crown corporation to a publicly-traded company. The Province of Manitoba converted $400 million in long-term debt owed to it by MTS into 70 million Common Shares, and one special share. The Province then sold the Common Shares to the public at $13 per share. The effect on MTS was to reduce long-term debt by $400 million and to increase shareholders' equity by $400 million.

In recent years, MTS has focused its resources to improve operating cost performance. Overall, operating expenses increased by 7.8%. Excluding the costs required to respond to the significant increase in MTS cellular subscribers, growth in operations costs remained essentially flat in 1996.

Local service revenues

	1996	1995	% Change
	(in thousands)		
Revenue			
Residence	$ 111,192	$ 93,408	19.0
Business	117,716	105,509	11.6
Other local	33,803	30,531	10.7
	$ 262,711	$ 229,448	14.5
Network access lines			
Residence	452,595	450,881	.4
Business	214,315	207,136	3.5
Total	666,910	658,017	1.4

Local service revenues increased by $17.8 million for residence services, $12.2 million for business services and $3.3 million for other services. The increases resulted primarily from a local rate increase of $2.00 per month effective January 1, 1996 as directed by *Telecom Decision CRTC 95-21*, as well as the enhancement of existing services, the introduction of new optional calling features and call management services, and the consolidation of rate groups from ten to three in Manitoba.

Long distance revenues

	1996	1995	% Change
	(in thousands)		
Inter	$ 143,201	$ 135,138	6.0
Intra	90,227	103,818	(13.1)
	$ 233,428	$ 238,956	(2.3)
Long distance minutes (000's)	739,135	727,919	1.5

Long distance revenues are derived from services originating and terminating within Manitoba (intra revenue), and from services provided jointly with other telecommunications companies (inter revenue). Intra revenues declined by $13.6 million or 13% due to the impact of a full year of equal access in Winnipeg and Brandon combined with the continued roll-out of equal access throughout the province; the migration of customers to savings plans with deeper discounts; and the expansion of Community Calling™ services.

The decline in intra revenues was partially offset by a $8.1 million or 6.0% increase in inter revenues due to higher national revenues available for settlement. Revenues for long distance services that cross provincial and national bounderies are shared based on an agreement among the Stentor member companies.

Other revenues

	1996	1995	% Change
	(in thousands)		
Wireless	$ 58,081	$ 40,765	42.5
Directory	27,339	26,519	3.1
Miscellaneous	7,766	4,439	74.9
	$ 93,186	$ 71,723	29.9
Cellular customers	86,256	62,893	37.1
Cellular revenue per customer/per month	$ 71.23	$ 75.45	(5.6)

Other revenues have increased largely due to the continued growth in the cellular market. In 1996, the Company continued to lead the Manitoba wireless market in sales, service and coverage. With the investment in new cellular sites during the year, the Company now offers coverage to over 95% of the Manitoba population.

Operating expenses

	1996	1995	% Change
	(in thousands)		
Operations	$ 319,190	$ 302,037	5.7
Depreciation	165,392	147,302	12.3
Operating expenses	$ 484,582	$ 449,339	7.8

Operating expenses increased by $35.2 million or 7.8% primarily due to higher depreciation expenses, higher sales and marketing expenses, and a $13.1 million increase in customer service and support costs in the cellular business resulting from growth in the subscriber base. The increase in depreciation expense of $18.1 million or 12.3% is the result of higher depreciation rates due to reduced service lives and increases in depreciable telecommunications property.

Debt charges

	1996	1995	% Change
	(in thousands)		
Debt charges	$ 84,921	$ 90,339	(6.0)
Average weighted cost of debt at year end	8.9%	9.4%	

Debt charges decreased during the year due to a decrease in the amount of long-term debt, an improved cash position which decreased short-term borrowings, and a decrease in both short-term and long-term interest rates. The average weighted cost of debt declined, following the recapitalization, from 8.9% to 7.2%, excluding the debt servicing administration fee charged to MTS by the Province of Manitoba.

LIQUIDITY AND CAPITAL RESOURCES

	1996	1995	Increase
	(in thousands)		
Cash and cash equivalents	$ 50,701	$ 5,941	$ 44,760
Changes during 1996:			
Cash provided by operating activities	$ 187,047	$ 153,404	21.9%
Cash (used for) investing activities	(124,549)	(151,537)	(17.8)%
Cash (used for) provided by financing activities	(17,738)	12,312	
Increase in cash	$ 44,760	$ 14,179	

Cash provided by operating activities increased by $33.6 million or 21.9% primarily due to increased operating revenues of $49.2 million and a decrease in debt charges of $5.4 million offset by an increase in operations expense of $17.2 million.

Cash used for investing activities decreased by $27.0 million or 17.8% primarily due to a decrease in construction program expenditures and an increase in the assets held for pension obligations. The decrease in construction program expenditures is due to the completion of the Service for the Future initiative and a delay in construction activities due to spring flooding which occured throughout many areas of Southern Manitoba in 1996.

Financing activities used cash of $17.7 million to reduce long-term debt, and pay down the long-term trade payable.

PRO-FORMA RESULTS

Pro-forma information has been calculated as though the application of the Company's sinking fund assets against the long-term debt and the conversion of $400 million of long-term debt into 70 million Common Shares had occurred on January 1, 1996. For this calculation, net income has been increased by $43.3 million which represents the elimination of the 1996 interest expense and the debt administration fee on $400 million of converted long-term debt, net of interest income which would have otherwise been earned on the sinking fund.

Pro-forma

	1996
Net income *(in millions)*	$ 75.7
Return on equity	11.3%
Earnings per share	$ 1.08
Return on assets	11.1%
Debt ratio	39.1%
Weighted average cost of debt	7.2%

This outlook as well as certain other sections of this report, contains forward-looking statements with respect to MTS. These forward-looking statements by their nature, necessarily involve risks and uncertainty that could cause actual results to differ materially from those contemplated by the forward-looking statements.

MTS operates primarily within the province of Manitoba. As a major regional full-service provider with more than 660,000 network access lines, MTS is affected by economic conditions that impact its broad base of residential and business customers throughout Manitoba. The provincial economy has been performing solidly in recent years. The provincial gross domestic product (GDP) grew by 4.1% in 1995, outpacing the national average of 3.9%. Manitoba is expected to have outperformed the national GDP average again in 1996.

The economic outlook for 1997 is for continued growth and stable market conditions in Manitoba. This should have a favourable impact on the Company's business performance. In addition, the provincial economy is increasingly export-based. Today, Manitoba businesses rely on advanced communications and networking capabilities to coordinate activities with customers and suppliers outside the province. The increasing reliance on communications in a more globalized economy is favorable to the growth potential of MTS and other telecommunications companies providing services to businesses and consumers in Manitoba.

Operations

Management expects to deliver increased operating revenues in 1997 because of continuing growth in the cellular market; a $2.00 per month increase in local rates effective on January 1, 1997; the impact of a full year with a consolidated rate structure; and the increasing market penetration of enhanced optional calling features. In particular, management expects continued growth in wireless revenues because of increased market acceptance of cellular and paging services. This is expected to provide revenue growth consistent with the levels experienced in 1996.

The Canadian Radio-television and Telecommunications Commission, (CRTC), regulates the Canadian telecommunications industry. A CRTC-approved local rate increase of $2.00 per month, effective January 1, 1997 is expected to provide an additional $14 million in revenues during 1997. In addition, the re-alignment and re-structuring of rate groups by MTS, as approved by the CRTC, resulted in additional revenues of $3 million in 1996 and is expected to generate $7 million in revenues for 1997.

In 1996, MTS completed a major network modernization initiative, Service For the Future, to bring individual line service and digital switching to all Manitoba communities. Manitoba is one of only four provinces to have achieved this milestone. With its network modernization completed, MTS can cost-efficiently deliver an expanding range of advanced optional calling features to a broad customer base across its large operating region. Management expects increased penetration of calling features to provide an increase in revenues in 1997.

Anticipated revenue growth in the areas mentioned above is expected to be marginally offset by a decrease in long distance revenues arising from intensifying competition. The number of long distance minutes and long distance messages increased in 1996. These trends are expected to continue in 1997. MTS is the preferred long distance supplier in Manitoba with an estimated 85% market share at year-end 1996.

MTS will continue to focus on managing operating costs in 1997. A voluntary workforce reduction program instituted in early 1997 is expected to produce savings of approximately $4 million. Management anticipates maintaining its top-third ranking among Canadian telecommunication operating companies with respect to operating costs per network access line.

Management expects a significant decrease in debt charges because of the recapitalization of MTS completed on January 7, 1997. This recapitalization resulted in a decrease in the net long-term debt balance of $400 million and a decrease in the average weighted cost of debt from 8.9% to 7.2%.

MTS became a taxable corporation following completion of its initial public offering. The Company will not pay income tax for the next several years as a result of a federal income tax ruling on the deductibility of company-funded contributions to the MTS pension plan. The ruling will permit MTS to deduct contributions made to its pension plan from taxable income. The resulting non-capital losses of $383 million can be utilized to reduce the taxable income of MTS and its subsidiaries up to a maximum of seven years.

Liquidity and capital resources

Planned capital expenditures are $165 million for 1997. Capital programs include enhancing and growing the MTS digital network; expanding data and integrated services networking capabilities; investing in management information systems; investing in a wireless PCS network; expanding the existing mobility/cellular network infrastructure; and further developing the Company's online multimedia infrastructure to serve its expanding base of Internet customers. These capital expenditures are expected to be fully financed from internally generated funds.

The recapitalization of MTS has resulted in the conversion of $400 million of long-term debt into equity which significantly strengthens the Company's capital structure. The debt conversion and repayment agreement with the Province of Manitoba requires the repayment of the remaining debt to the Province prior to December 31, 2000 in amounts between $80 million and $125 million per year. Therefore external financing may be required to refinance this debt. In order to facilitate this refinancing, the Company has arranged a credit facility of $25 million with a Canadian chartered bank and has implemented a commercial paper program authorized to a maximum of $100 million, thereby ensuring adequate liquidity to meet the Company's working capital needs.

MTS' current credit ratings are:

	Senior Debentures	Commercial Paper
Canadian Bond Rating Service	A	A-1
Dominion Bond Rating Service	A (low)	R-1 (low)

The MTS Board has established an initial policy of paying quarterly cash dividends on Common Shares. The Company declared a $0.17 per share dividend in the first quarter of 1997. It is anticipated that internally generated funds will be sufficient to fully fund capital expenditures and shareholder dividend payments in 1997. In addition to paying dividends and funding capital expenditures the Company expects to generate free cash flow in 1997.

Patent Infringement Claim

The Stentor member companies (BC TEL, TELUS Communications Inc., Saskatchewan Telecommunications, MTS NetCom Inc., Bell Canada, Québec-Telephone, The New Brunswick Telephone Company Limited and NewTel Communications Inc.), Stentor Canadian Network Management, Stentor Resouce Centre Inc., Stentor Services Inc., AT&T Corp., AT&T Canada Long Distance Services Company and MCI settled their litigation concerning several AT&T patents. Related litigation in the U.S.A. was also settled. Details of the settlement are confidential.

The competitive and market environment in which MTS operates is governed by the CRTC which regulates telecommunications carriers under the authority of The *Telecommunications Act* (Canada). The CRTC has authority over certain aspects of telecommunications carrier operations including rates, service packages, quality of service, costing and accounting practices. The *Telecommunications Act,* however, obliges the CRTC to forbear from regulation of rates and service conditions where it determines that there is sufficient competition to protect the interests of consumers.

MTS NetCom is regulated by the CRTC as a telecommunications common carrier. MTS NetCom replaced MTS as the common carrier in Manitoba when MTS transferred its telephone company operations and assets to MTS NetCom as part of the restructuring of the Company which became effective January 1, 1996.

As a result of *Telecom Decision CRTC 94-19*, the CRTC split MTS NetCom's rate base into utility and competitive segments. The utility segment includes most of MTS NetCom's local services. This segment currently is regulated on a rate of return (ROE) basis. This allows the Company to earn a specified rate of return on the common equity within its utility segment. The competitive segment is not subject to earnings regulation. Competitive segment services include long distance and data and terminal service offerings, which are subject to competition in the marketplace. MTS NetCom is required to file tariffs for its local and many of its competitive long distance services and to demonstrate that its services cover their costs and underlying charges.

The CRTC has initiated a proceeding under *Telecom Public Notice CRTC 96-26* to determine whether the long distance market is sufficiently competitive to allow it to forebear from the regulation of the long distance services of the telephone companies. A decision is expected later in 1997. In 1995, the CRTC determined that it would forbear regulating the long distance services of carriers other than the telephone company carriers.

The CRTC maintains the authority to impose general conditions on the provision of cellular and wireless voice services to prevent unjust discrimination and the conferring of undue preferences. However the CRTC has relieved MTS Mobility of the requirements to file tariffs for its services. MTS NetCom and MTS Mobility currently are restricted from joint marketing, joint billing and bundling of their services.

The CRTC will implement a price cap regulatory mechanism for telephone companies' utility segments effective January 1, 1998. Under a price cap regime, utility services will be grouped into a number of service baskets. Initial prices for each basket will be capped after which annual price changes will be adjusted by an inflation factor and a pre-determined offset representing assumed levels of productivity improvement. Price cap regulation will apply only to local utility services and is intended as an interim form of regulation as the market in local telephone services becomes more competitive.

In addition the CRTC currently is considering the terms and conditions for competition in local telephone services. The telephone companies will be required to unbundle essential components of their local facilities into discrete components that will be made available to competitors at tariffed rates. This is intended to permit new entrants to provide competitive local services without completely replicating the local networks of the telephone companies. A decision on the terms and conditions of competition in local telephone services is expected in the second quarter of 1997.

The federal government's Convergence Policy Statement issued in August 1996 announced that competition in the broadcast industry will be permitted on the same timetable as competition in local telephone service. Telephone companies, therefore will be allowed to hold broadcast licenses as soon as the barriers to competition in local telephone services have been removed and tariffs relating to entry into the local telephone service market are in place.

FINANCIAL STATEMENTS

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS

The accompanying financial statements of The Manitoba Telephone System and the information in the annual report are the responsibility of management and have been approved by the MTS Board of Directors.

The financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. The financial statements necessarily include some amounts that are based on management's best estimates and judgements. Financial information presented elsewhere in the annual report is consistent with that in the financial statements.

In fulfilling their responsibilities, management have developed and continue to maintain a system of internal controls including written policies and procedures, segregation of duties and responsibilities and an internal audit program. This system is designed to provide reasonable assurance that assets are adequately accounted for and safeguarded, transactions are properly authorized and recorded and the financial records are reliable for preparing the financial statements.

The MTS Board of Directors carries out its responsibilities for the financial statements in the annual report principally through its Audit Committee. The Audit Committee meets periodically with management and with the internal and external auditors to discuss the results of audit examinations with respect to the adequacy of internal controls and to review and discuss the financial statements. The Audit Committee recommends the financial statements to the Board for approval.

The financial statements have been audited by Deloitte & Touche, Chartered Accountants, who have full access to the Audit Committee, with and without the presence of management. Their report follows.

Bill Fraser
President & Chief Executive Officer

Cheryl Barker
Vice-President Finance & Chief Financial Officer

AUDITORS' REPORT

To the Board of Directors, Manitoba Telecom Services Inc. (the successor corporation to The Manitoba Telephone System)

We have examined the consolidated balance sheet of The Manitoba Telephone System as at December 31, 1996, and 1995 and the consolidated statements of income and retained earnings and changes in financial position for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1996 and 1995 and the results of its operations and changes in its financial position for the years then ended in accordance with generally accepted accounting principles.

Deloitte & Touche

Chartered Accountants
Winnipeg, Manitoba
January 31, 1997

CONSOLIDATED BALANCE SHEET

ASSETS

	December 31	
	1996	1995
	(in thousands)	
Current assets		
Short-term investments	$ 50,701	$ 12,500
Accounts receivable	94,806	79,981
Prepayments	10,347	9,411
	155,854	101,892
Property, plant and equipment		
Buildings, plant and equipment	2,144,590	2,104,392
Less: accumulated depreciation	1,121,896	1,036,797
	1,022,694	1,067,595
Land	6,281	6,388
Plant under construction	24,648	15,139
Materials and supplies	10,650	12,889
	1,064,273	1,102,011
Other assets		
Investments *(Note 3)*	16,795	13,153
Deferred charges *(Note 4)*	26,998	17,087
Investments held for pension obligations *(Note 8)*	343,006	313,875
Investment in leases	1,191	1,072
	387,990	345,187
	$ 1,608,117	$ 1,549,090

	December 31 1996	1995
	(in thousands)	
Current liabilities		
Bank indebtedness	$ –	$ 6,559
Accounts payable and accrued liabilities	100,036	69,184
Advance billings and payments	17,537	12,036
Accrued interest	25,583[1]	29,501
Short-term notes payable	–	17,500
Debt due within one year *(Note 9)*	178,813	185,265
	321,969	320,045
Long-term debt (Note 10)		
Advances and notes payable	673,685	683,532
Less: sinking fund assets	25,694	26,045
	647,991	657,487
Other liabilities		
Long-term trade payable	3,113	4,715
Deferred employee benefits *(Note 5)*	369,904	334,103
	373,017	338,818
Total liabilities	1,342,977	1,316,350
Retained earnings	265,140	232,740
	$ 1,608,117	$ 1,549,090

Approved on behalf of the Board

Chairman

Director

CONSOLIDATED STATEMENT OF INCOME AND RETAINED EARNINGS

	Years ended December 31	
	1996	1995
	(in thousands)	
Operating revenues		
Local service	$ 262,711	$ 229,448
Long distance service	233,428	238,956
Other	93,186	71,723
	589,325	540,127
Operating expenses		
Operations	319,190	302,037
Depreciation	165,392	147,302
	484,582	449,339
Net operating revenues	104,743	90,788
Other income *(Note 6)*	12,578	14,668
Income before debt charges	117,321	105,456
Debt charges *(Note 7)*	84,921	90,339
Net income	32,400	15,117
Retained earnings, beginning of year	232,740	217,623
Retained earnings, end of year	$ 265,140	$ 232,740

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

Years ended December 31

	1996	1995
	(in thousands)	
Operating activities		
Net income	$ 32,400	$ 15,117
Depreciation	165,392	147,302
Cash (used for) provided by changes in working capital	(826)	6,679
Payments towards deferred employee benefits	(5,070)	(5,122)
Other items	(4,849)	(10,572)
Cash provided by operating activities	187,047	153,404
Financing activities		
(Decrease) increase in long-term trade payable	(1,602)	4,715
Issuance of long-term debt	140,401	116,767
Repayment of long-term debt	(162,597)	(111,154)
Sinking fund withdrawals	16,536	12,484
Contribution to sinking fund	(10,476)	(10,500)
Cash (used for) provided by financing activities	(17,738)	12,312
Investing activities		
Construction program expenditures (net)	(135,199)	(155,931)
Increase in investments held for pension obligations	(29,131)	(23,264)
Earnings on investments held for pension obligations	43,542	25,320
(Increase) decrease in investments	(3,642)	251
(Increase) decrease in investments in leases	(119)	2,087
Cash used for investing activities	(124,549)	(151,537)
Increase in cash	44,760	14,179
Cash, beginning of year	5,941	(8,238)
Cash, end of year	$ 50,701	$ 5,941

Cash represents short-term investments less bank indebtedness.

For the years ended December 31, 1996 and 1995

1. Summary of significant accounting policies

a) General

The Manitoba Telephone System is incorporated by virtue of the provisions of *The Manitoba Telephone Act*, as a Crown corporation of the Province of Manitoba.

The Manitoba Telephone System operates in a single industry segment which is telecommunications services. The Company's principal subsidiary MTS NetCom Inc., is regulated under the *Telecommunications Act* by the Canadian Radio-television and Telecommunications Commission (CRTC). In its role as regulator, the CRTC sets the allowed rate of return, and approves tariffs and interconnection and working agreements with other carriers. It also periodically issues directives that affect the accounting treatment of specific items in the Company's accounts.

The financial statements are prepared in accordance with generally accepted accounting principles and follow practices similar to those being used in the Canadian telecommunications industry.

The term "Company" is used to mean The Manitoba Telephone System and, where the context of the narrative permits or requires, its subsidiaries.

b) Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, namely MTS NetCom Inc., MTS Mobility Inc., and MTS Advanced Inc., which were formed effective January 1, 1996.

c) Regulation

The CRTC issued *Telecom Decision CRTC 94-19* and *Telecom Decision CRTC 95-21* which have significant impacts on the form of regulation of telecommunications companies in Canada. Significant changes include moving from rate of return regulation to price cap regulation in 1998, applying minimal regulation to competitive segments, and allowing more competition in local exchange markets.

d) Deferred charges

Deferred charges includes deferred commissions which are amortized over the period of expected benefits and costs associated with employee reduction programs which are deferred and amortized over five years.

e) Property, plant and equipment

Property, plant and equipment is recorded at original cost including materials, direct labour and certain overhead costs associated with construction activity and an allowance for the cost of funds during construction.

f) Depreciation

Depreciation is calculated on a straight-line basis over the estimated useful life of property, plant and equipment by applying rates that are based on a continuing program of engineering studies. The composite depreciation rate for the year ended December 31, 1996 was 7.7% (1995 – 7.1%).

When depreciable telephone property is retired, the original cost of such property is charged to accumulated depreciation.

g) Translation of foreign currencies

Foreign currencies have been translated into Canadian dollars at rates of exchange on the following basis:

i) Monetary assets and liabilities at effective rates prevailing at the end of the year;
ii) Revenues and expenses at rates prevailing at the respective transaction dates.

h) Amortization of bond premiums and discounts in sinking fund investments
Bond premiums and discounts arising from the purchase of bonds at other than face value are amortized over the remaining life of the bond.

i) Amortization of long-term debt costs
Costs associated with the issuance of long-term debt are included in deferred charges and amortized over the term of the original issue.

j) Leases
For leases which qualify as sales-type leases, the sales revenue is recognized at the effective date of the lease. Finance income related to sales-type leases is recognized over the life of the lease. Revenue from operating leases is accounted for at the time the services are provided to customers.

k) Financial instruments
The Company's financial assets and liabilities are initially recorded at the related transaction amount, which is normally the historical cost. When the carrying value of a financial asset exceeds its fair value on a basis which is other than temporary, the carrying value is reduced to its fair value.

For the Company's current financial assets and liabilities, which are subject to normal trade terms, the historical cost carrying amount approximates the fair value. The Company's long-term debt, which is disclosed in Note 10, was restructured subsequent to December 31, 1996 as described in Note 13. The debt, which remains following the restructuring, will not be readily marketable because of the associated terms and conditions. As a consequence, it is not practicable to determine the fair value of the Company's long-term debt with sufficient reliability to disclose it in these financial statements.

During the years ended December 31, 1996 and 1995, the Company has not utilized any derivative financial instruments.

2. Change in accounting policies

a) Software development costs
Effective January 1, 1995, The Manitoba Telephone System changed its method of accounting for costs associated with developing and implementing non-national software development projects from expensing internal salaries and other related costs incurred on these projects to capitalizing all such costs. This treatment is consistent with existing accounting policies for national software development projects.

The accounting policy change was applied on a prospective basis and was made to conform to changes in Generally Accepted Accounting Principles and to remain consistent with the treatment of development costs in other telecommunications companies. The capitalized costs are amortized on a straight-line basis at the rate of 20% per year. Increases in property, plant and equipment, decreases in operating expenses and increases in net income amounted to $2.2 million in 1995.

b) Salvage and interim removal and reinstallation costs
Effective January 1, 1995, The Manitoba Telephone System changed its method of accounting for salvage and interim removal and reinstallation costs from adjusting accumulated depreciation for salvage and capitalizing removal and reinstallation costs to the following:

i) Labour and material costs incurred on interim removals and reinstallations associated with the relocation of assets are expensed. Interim salvage is not recorded on asset relocations.

ii) Final removal costs on the retirement of assets are expensed. Salvage on final disposition is taken into revenue as realized.

This accounting policy change was made to provide consistency with other Canadian telecommunications companies. The change has been applied on a prospective basis and resulted in a net decrease in property, plant and equipment and net income for the year ended December 31, 1995 in the amount of $2.8 million.

3. Investments

	1996	1995
	(in thousands)	
Investments carried at cost		
Long-term disability fund	$ 3,885	$ 3,793
Alouette Telecommunications Inc. shares	7,560	7,560
Other investments carried at equity	5,350	1,800
	$ 16,795	$ 13,153

The market value of the long-term disability fund at December 31, 1996 totalled $4,597,000 (1995 – $4,255,000).

4. Deferred charges

	1996	1995
	(in thousands)	
Employee reduction program	$ 13,449	$ 6,937
Deferred commissions	12,978	7,960
Other	571	2,190
	$ 26,998	$ 17,087

Amortization expense amounted to $13,331,000 for the year ended December 31, 1996 (1995 – $6,449,000).

5. Deferred employee benefits

	1996	1995
	(in thousands)	
Pension *(Notes 8 and 13)*	$ 343,006	$ 313,875
Vested sick leave	12,170	13,953
Long-term disability	6,464	6,275
Other	8,264	–
	$ 369,904	$ 334,103

6. Other income

	1996	1995
	(in thousands)	
Investment income	$ 3,509	$ 4,117
Surcharge on overdue accounts	3,959	3,578
Interest charged to construction *(Note 1 (e))*	1,231	3,379
Other, net	3,879	3,594
	$ 12,578	$ 14,668

7. Debt charges

	1996	1995
	(in thousands)	
Interest on long-term debt	$ 80,139	$ 84,354
Amortization of long-term debt costs	23	81
Other interest expense and debt charges	4,759	5,904
	$ 84,921	$ 90,339

8. Pensions

a) Pension plan

Employees of the Company are pensionable under The Civil Service Superannuation Fund (the Fund) established under *The Civil Service Superannuation Act* (Manitoba), and make contributions to the Fund at prescribed rates. The Fund is a defined benefit final average pension plan which covers substantially all of the Company's employees. The Fund provides pensions based on length of service and final average earnings *(Note 13 (b))*.

b) Investments held for pension obligations

Investments held for pension obligations are recorded at cost. The market value of investments at December 31, 1996 totalled $379,055,000 (1995 – $334,808,000). The investments are administered by external investment managers *(Note 13 (b))*.

c) Pension liability

Based on an actuarial valuation completed January 1, 1995, the Company had a liability for pension obligations at December 31, 1996 of approximately $359,166,000 (1995 – $339,291,000). This liability is based on the assumption that future pensions will be increased due to increases in the cost of living *(Note 13 (b))*.

9. Debt due within one year

	1996	1995
	(in thousands)	
Advances and notes payable due within one year	$ 187,935	$ 200,284
Less: sinking fund assets allocated to advances and notes payable due within one year	9,122	15,019
Debt due within one year *(Note 13 (a)(ii))*	$ 178,813	$ 185,265

10. Long-term debt

a) Advances and notes payable

	1996	1995
	(in thousands)	
Province of Manitoba advances		
Series AX, 7.87%, due May 20, 1996	$ –	$ 64,092
Advance UFA2, 9.52%, due September 26, 1996	–	65,600
Series UFA30, 4.60%, due January 8, 1997	3,819	–
Series BC, 8.75%, due February 5, 1997	3,704	3,704
Advance UFA3, 10.75%, due February 5, 1997	80,455	80,455
Advance UFA31, 4.10%, due March 31, 1997	57,957	–
Advance UFA6, 11.50%, due September 28, 1997	20,000	20,000
Advance UFA32, 5.15%, due October 1, 1997	22,000	–
Advance UFA7, 11.25%, due January 16, 1998	8,780	8,780
Advance UFA33, 5.42%, due March 31, 1998	56,625	–
Advance UFA20, 7.00%, due August 20, 1998	9,642	9,642
Advance UFA16, 9.00%, due June 5, 1999	7,484	7,484
Series 11A, 10.25%, due August 1, 1999*	–	5,000
Advance UFA17, 7.625%, due September 30, 1999	23,000	23,000
Advance UFA4, 11.5%, due June 29, 2000	20,000	20,000
Advance UFA5, 11.125%, due August 7, 2000	96,878	96,878
Advance UFA8, 10.375%, due April 26, 2001	40,000	40,000
Advance UFA9, 11.00%, due July 2, 2001	42,374	42,374
Advance UFA12, 9.00%, due January 27, 2002**	24,847	30,752
Advance UFA14, 9.25%, due March 27, 2002	40,000	40,000
Advance UFA15, 9.375%, due March 31, 2003	34,754	34,754
Advance UFA19, 8.50%, due May 14, 2003	18,129	18,129
Advance UFA18, 9.75%, due February 15, 2004	10,000	10,000
Advance UFA21, 8.25%, due July 2, 2004	7,484	7,484
Advance UFA11, 9.50%, due December 2, 2004	11,799	11,799
Advance UFA23, 7.75%, due March 1, 2005	25,374	25,374
Advance UFA25, 8.75%, due May 15, 2005	44,175	44,175
Advance UFA22, 7.75%, due September 30, 2005	16,000	16,000
Advance UFA28, 8.00%, due April 17, 2006	48,592	48,592
Advance UFA10, 9.75%, due November 15, 2006	14,150	14,150
Advance UFA24, 9.00%, due May 2, 2007	14,968	14,968
Advance UFA26, 8.50%, due September 29, 2007	12,000	12,000
Advance UFA13, 9.125%, due April 3, 2008	34,630	34,630
Advance UFA27, 8.625%, due September 8, 2010	12,000	12,000
	861,620	861,816
Notes payable		
Province of Manitoba note, 6.75%, due January 19,1996	–	22,000
	861,620	883,816
Less: portion due within one year *(Note 13 (a)(ii))*	187,935	200,284
Total advances and notes payable *(Note 13 (a)(ii))*	$ 673,685	$ 683,532

* *Redeemed at MTS' option in 1996*

** *Annual partial repayments*

b) Sinking fund

	1996	1995
	(in thousands)	
Sinking fund assets *(Note 13 (a)(ii))*	$ 34,816	$ 41,064
Less: assets allocated to advances and notes payable due within one year *(Notes 9 and 13 (a)(ii))*	9,122	15,019
	$ 25,694	$ 26,045

Under the requirements of *The Manitoba Telephone Act*, the Company is required to make a contribution to the Minister of Finance of the Province of Manitoba, as trustee for the sinking fund. The sinking fund contribution for the year ended December 31, 1996 was $10,476,000 (1995 –$10,500,000). The market value of the investments held in the fund at December 31, 1996 was $36,699,000 (1995 –$42,134,000).

11. Commitments

a) Lease commitments

The Company rents buildings and construction and other equipment under operating leases. Future minimum lease commitments are as follows:

	(in thousands)
1997	$ 3,725
1998	2,741
1999	1,559
2000	1,202
2001	1,109

b) Option to purchase

During 1994, the Company entered into an agreement with a third party that would allow for the third party to exercise an exclusive, one-time option to purchase not less than ten percent and not more than twenty percent of the Company's Yellow Pages™ business. The option expires on August 24, 1997.

c) Contractual obligations

The Company has entered into various long-term contractual commitments for services required in the normal course of operations. These commitments expire on various dates ranging between four and seven years. Future contractual commitments for these services are as follows:

	(in thousands)
1997	$ 20,135
1998	18,194
1999	21,402
2000	17,872
2001	15,694

12. Related party transactions

The Company carries on ordinary business transactions with the Province of Manitoba and various entities controlled by the Province of Manitoba on the same terms and conditions as transactions with unrelated parties. In accordance with legislative requirements, the Company also paid various taxes to the Province of Manitoba during the year in the amount of $10.6 million. The amount due from this related party included in accounts receivable, as at December 31, 1996 was $922,000.

In addition, the Company has obtained advances and notes payable from the Province of Manitoba as described in Note 10 and substantially all of the Company's debt charges, including interest and administration fees are paid to the Province of Manitoba. As at December 31, 1996, the entire amount of the Company's liability for accrued interest was owing to the Province of Manitoba.

13. Subsequent events

a) The Manitoba Telephone System Reorganization and Consequential Amendments Act (the Reorganization Act) was passed by the Legislature of the Province of Manitoba (the Province) on November 28, 1996. Upon the proclamation of the Reorganization Act on January 7, 1997, the following significant events and transactions became effective:

i) The Manitoba Telephone System was continued as a share capital corporation operating under the name Manitoba Telecom Services Inc.

ii) The Company's indebtedness to the Province was refinanced pursuant to the terms of the Debt Conversion and Repayment Agreement between the Company and the Province. Under the terms of this agreement, the Province applied the sinking fund assets of the Company against the debt owed to it by the Company and then converted $400 million of the debt into 70 million Common Shares and a Special Share of the Company.

Accordingly, the shareholders' equity of the Company increased by $400 million and the long-term debt decreased by $400 million. The details of the specific debt instruments that remain after conversion are described in the following table:

	Continuing debt
	(in thousands)
Advances payable	
Advance UFA30, 4.60% due January 8, 1997	$ 3,819
Series BC, 8.75%, due February 5, 1997	3,273
Advance UFA31, 4.10% due March 31, 1997	57,957
Advance UFA32, 5.15%, due October 1, 1997	19,972
Advance UFA33, 5.42%, due March 31, 1998	56,625
Advance UFA20, 7.00%, due August 20, 1998	9,341
Advance UFA16, 9.00%, due June 5, 1999	7,166
Advance UFA17, 7.625%, due September 30, 1999	22,023
Advance UFA12, 9.00%, due January 27, 2002	23,413
Advance UFA19, 8.50%, due May 14, 2003	17,563
Advance UFA21, 8.25%, due July 2, 2004	7,250
Advance UFA23, 7.75%, due March 1, 2005	24,856
Advance UFA25, 8.75%, due May 15, 2005	43,733
Advance UFA22, 7.75%, due September 30, 2005	15,501
Advance UFA28, 8.00%, due April 17, 2006	48,106
Advance UFA24, 9.00%, due May 2, 2007	14,662
Advance UFA26, 8.50%, due September 29, 2007	11,880
Advance UFA13, 9.125%, due April 3, 2008*	27,697
Advance UFA27, 8.625%, due September 8, 2010	11,880
Total debt	426,717
Less: amounts related to advances payable due within one year	85,021
Long-term portion of debt	$ 341,696
Average weighted cost of debt	7.2%

* *Partially paid on the closing date.*

Pursuant to the terms of the Debt Conversion and Repayment Agreement, the continuing debt is now subject to substantially altered repayment terms and due dates. The continuing debt is secured by a floating charge against the assets of the Company. In the case of Advances payable with stated due dates prior to December 31, 2000, as listed above, repayment is required according to these stated due dates. In the case of Advances payable with stated due dates subsequent to December 31, 2000, as listed above, the Company has the option to repay advances in whole or in part at any time before December 31, 2000. However, the Debt Conversion and Repayment Agreement requires minimum repayments of $80 million and allows maximum repayments of $125 million in each of the four years ending December 31, 1997 to December 31, 2000 irrespective of the original due dates. The right to repay up to $125 million in each year is non-cumulative.

All continuing debt must be repaid by December 31, 2000, and any debt repaid that had a maturity date falling after December 31, 2000 must be repaid at market value at the date of repayment. As at January 7, 1997 the estimated excess of the market values of such debt over the book values at the anticipated time of repayment is $11.1 million. This amount was accrued as a liability and charged directly to retained earnings of the Company.

iii) The Province sold the 70 million Common Shares to the public for cash consideration of $13.00 per share under a prospectus offering. No portion of the proceeds has been or will be received by the Company, nor will the related costs of the offering be incurred by the Company.

iv) Subsequent to the sale of the Common Shares to the public, the tax status of the Company and each of its subsidiaries changed from being a tax exempt entity to being a taxable corporation.

b) On January 1, 1997 the Company established a new pension plan (the "new Pension Plan") to be registered under the *Pension Benefits Standards Act*, 1985 (Canada) and the *Income Tax Act* (Canada), which provides benefits that are equivalent in value, on the implementation date, to the pension benefits to which employees and retirees of the Company and other beneficiaries have or may have become entitled under *The Civil Service Superannuation Act* (Manitoba) *(Note 8)*. As part of the establishment of the new Pension Plan, a trust fund will be created by the Company which will hold all monies and assets relating to the new Pension Plan.

The Company intends to transfer its investments held for pension obligations, which had a market value at December 31, 1996 of approximately $379,055,000 *(Note 8)*, to the new Pension Plan trust fund. As a result of this transfer, the investments held for pension obligations and the corresponding pension liability *(Note 8)* will be removed from the Company's balance sheet.

As soon as is practicable following the reorganization and the establishment and registration of this new Pension Plan, the share of total assets of The Civil Service Superannuation Fund (CSSF) that relates to current and former employees of the Company will be transferred from the CSSF to the new Pension Plan trust fund. Thereafter, the Company will have sole responsibility for funding any deficiencies in the new Pension Plan that may arise. In anticipation of this event, the Company obtained an actuarial opinion which confirmed that if the transfers of assets referred to above had occurred on September 30, 1996, the new Pension Plan would have been fully funded.

c) The Company has received an advance federal income tax ruling respecting the tax deductibility of the Company's contributions to the new Pension Plan. The resulting non-capital losses can be utilized to reduce the taxable income of the Company and its subsidiaries over a maximum period of seven years. At December 31, 1996, the Company had investments with a market value of approximately $379,055,000 which were available for contribution to the new Pension Plan. The tax benefits of the deductions, the amount of which is subject to actuarial certification, will be recognized in the financial statements at the time they are realized.

14. Pro-forma basic earnings per share

The pro-forma basic earnings per share for the year ended December 31, 1996 is $1.08 per share. Pro-forma basic earnings per share has been calculated as though the application of the Company's sinking fund assets against the long-term debt and the conversion of $400 million of long-term debt into 70 million Common Shares *(Note 13 (a)(ii))* had occurred at January 1, 1996. For the purpose of this calculation, net income has been increased by $43.3 million which represents the elimination of the 1996 interest expense and administration fee on the $400 million of converted long-term debt, net of the interest income which would have otherwise been earned on the sinking fund.

15. Comparative figures

The prior period figures have been reclassified where necessary to conform to 1996 presentation.

FIVE YEARS IN REVIEW

(Not subject to auditors' report)

Statement of operations

(in thousands)	1996	1995	1994	1993	1992
Total operating revenues	$ 589,325	$ 540,127	$ 530,787	$ 538,616	$ 527,394
Total operating expenses	484,582	449,339	446,945	445,822	449,307
Other income	12,578	14,668	20,477	17,662	16,632
Debt charges	84,921	90,339	89,954	90,367	88,647
Net income	32,400	15,117	14,365	20,089	6,072
EBITDA	296,044	259,207	256,880	255,121	231,894

Balance sheet

(in thousands)					
Property, plant and equipment	$2,186,169	$2,138,808	$2,104,609	$2,058,139	$1,956,585
Accumulated depreciation	1,121,896	1,036,797	1,014,163	973,241	912,325
Investments and sinking funds	395,808	369,164	350,252	342,279	321,237
Long-term debt*	673,685	683,532	706,573	831,325	802,160
Retained earnings	265,140	232,740	217,623	203,258	183,169

Telephone statistics

Network access lines (NAL)	666,910	658,017	645,357	630,349	619,198
Network access services	919,244	864,372	779,406	735,497	713,497
Plant investment per NAL	$ 3,266	$ 3,250	$ 3,261	$ 3,265	$ 3,160
Long distance messages *(in thousands)*	180,049	176,559	159,671	155,010	152,658

Other statistics

Salaries and wages *(in thousands)*	$ 174,468	$ 189,024	$ 190,298	$ 194,293	$ 201,635
Number of employees	3,688	3,956	4,257	4,408	4,563
Operating costs per NAL**	$ 432	$ 431	$ 437	$ 461	$ 490
Long-term debt percentage of total invested capital	75.7	78.4	79.3	80.9	82.1
Debt charge coverage ratio	1.4	1.2	1.2	1.2	1.1
Net construction expenditures *(in thousands)*	$ 135,199	$ 155,931	$ 151,198	$ 170,010	$ 171,976

* *Prior year's figures have been restated to conform to 1996 presentation. Excludes long-term debt due within one year.*

** *Operating costs (excluding Depreciation and Mobility)*

MTS Board of Commissioners

(1996)

Thomas E. Stefanson
Chairman
The Manitoba Telephone System

Rubin Spletzer
President
Crystal Developments Ltd.

Edgar Penner *
President
Ed Penner Construction Ltd.

Lorraine Lemoine Taylor
Corporate Director

Denis C. Rocan
Member
Manitoba Legislative Assembly

D. Samuel Schellenberg
General Manager
Pembina Valley Development Corporation

Joyce R. A. Taylor
Manager, Department of Finance
Province of Manitoba

Bernard M. Thiessen
Financial Consultant
Manulife Financial

* *Resigned effective November 6, 1996*

MTS Board of Directors

(EFFECTIVE JANUARY 7, 1997)

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Manitoba Telecom Services Inc.

Robert M. Chipman
Chairman
The Megill-Stephenson Company Limited

Jocelyne M. Côté-O'Hara
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N. Ashleigh Everett
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William C. Fraser
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Manitoba Telecom Services Inc.

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The Great-West Life Assurance Company

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Donald H. Penny, F.C.A.
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Myers Norris Penny & Co.

Arthur R. Sawchuk
Chairman,
President & Chief Executive Officer
DuPont Canada Inc.

D. Samuel Schellenberg
General Manager
Pembina Valley Development Corporation

Officers

(EFFECTIVE JANUARY 7, 1997)

Thomas E. Stefanson
Chairman
Manitoba Telecom Services Inc. and
MTS NetCom Inc.

Rubin Spletzer *
Vice-Chairman
Manitoba Telecom Services Inc. and
Chairman of MTS Advanced Inc.

William C. Fraser
President & Chief Executive Officer
Manitoba Telecom Services Inc. and
MTS NetCom Inc.

Cheryl Barker
Vice-President Finance &
Chief Financial Officer
Manitoba Telecom Services Inc. and
Vice-President Finance MTS NetCom Inc.

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Executive Vice-President Strategic Planning
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Heather J. Nault
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Manitoba Telecom Services Inc.

Kathleen G. Desautels**
Corporate Secretary
Manitoba Telecom Services Inc.

Janice D. Buckingham***
Corporate Secretary
Manitoba Telecom Services Inc.

William F. Baines
President & Chief Operating Officer
MTS Net, a division of MTS NetCom Inc.

Donald H. Carr
President & Chief Operating Officer
MTS Com, a division of MTS NetCom Inc.

James M. Fitzgerald
President & Chief Operating Officer
MTS Mobility Inc.

Bruce G. MacCormack
President & Chief Operating Officer
MTS Advanced Inc.

* *Ceased to be an officer and chairman of MTS Advanced Inc., effective January 7, 1997.*

** *Resigned effective January 17, 1997*

*** *Appointed effective January 24, 1997*

Manitoba Telecom Services Inc.

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Share transfer agent and registrar

Montreal Trust Company of Canada
200 Portage Avenue
Mezzanine level
Winnipeg, Manitoba R3C 3X2
Telephone: (204) 985-3048

Market trading information

The Company's Common Shares and Instalment Receipts are listed on the Winnipeg, Toronto and Montreal stock exchanges. The trading symbols are:
Common Shares: MBT
Instalment Receipts: MBT. IR

Annual meeting

An Annual and Special Meeting of the shareholders of MTS will be held at the Crowne Plaza, Winnipeg, Manitoba, on May 30, 1997 at 11:00 am.

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